



EC Green Paper on Audit Policy: Lessons from the Crisis

A Nexia Response

Response to the Green Paper

Audit Policy: Lessons from the Crisis

Introduction

General Comments

Whilst clearly it is arguable the extent to which the structure of the audit market contributed to the financial crisis, we do consider it is helpful to use recent financial events as a trigger to reconsider the role and remit of audit. We welcome this opportunity to contribute to that debate and consider both the approach and purpose of the Green Paper to be appropriate.

We believe it is fundamental that the role of the auditor is acknowledged and understood by all stakeholders in global capital markets and that there is greater transparency.

We consider there is room for enhancement of audit quality. Competition and choice play an important role in developing that quality, but improvements will only be achieved if the future direction of the audit profession is based on a framework for audit delivery which is attractive professionally and financially, taking into account both risk and reward.

The Green Paper recognises the importance of distinguishing between large listed and systemic risk companies on the one hand and mid market and smaller companies on the other. We concur with this distinction and believe it is important that any reshaping of the audit market recognises not only the requirement for transparency but also the need to limit the regulatory burden on smaller companies.

As the 10th largest accounting network globally, we are well placed to provide insight into the global audit profession and equally well placed to put forward practical, workable ideas to address some of the concerns raised.

We have consulted widely within our network in formulating our response; we have received views from many of our European members, we have formed a working party comprising members of all of our major European audit practices and also sought input from the Nexia International Board. We are keen and ready to work with the European Commission and with Regulators to seek practical ways in which trust can be restored to the global audit profession.

Role of the Auditor

General comments

The Green Paper comments as follows:

'The Commission notes that the statutory audit has evolved from substantive verification of income, expenditure, assets and liabilities to a risk based approach'.

In our view this does not accurately reflect the nature of audit. Risk assessment lies at the heart of International Standards on Auditing ('ISA's), such that a combination of audit procedures, including substantive procedures, are designed such as to provide reasonable assurance that financial statements are true and fair.

Further, we consider it is a fundamental principle that reporting in accordance with the regulatory framework, whether that is IFRS or local GAAP, will result in financial reporting which is true and fair. Accordingly we would disagree with the Green Paper's assertion that:

'..reasonable assurance.....is less targeted at ensuring that the financial statements give a true and fair view and more geared to ensuring that the financial statements are prepared in accordance with the applicable reporting framework'.

Communication by auditors to stakeholders

Higher level of assurance to stakeholders

The Green Paper sets out its proposals for *'going back to basics'* in respect of audit procedures and also for setting out which particular balances have been *'directly verified and which were verified on the basis of professional judgement, internal models, hypotheses and management explanations'*.

As we note above, an efficient and effective audit will typically comprise a combination of audit procedures, including substantive procedures. The nature, extent and scope of those procedures will be responsive, inter alia, to the auditor's determination of risk. The work carried out on any particular component of a set of financial statements will therefore be a combination of procedures, not merely the substantive element. Accordingly we do not agree that communication to stakeholders on specific components of the financial statements is either achievable or indeed desirable. We do agree however that there is scope for improved reporting to those charged with governance; this may include establishing more detailed guidance for reporting as already applies in certain countries.

Auditor behaviour

We agree with the contention that auditors could play a larger role in challenging management from a user's perspective but share the stated concern that proliferation of disclosures which might serve to confuse stakeholders should be avoided. Accordingly, our view is that any additional audit scrutiny should result in increased reporting to the Board, the Audit Committee or Regulators, but not to shareholders in general.

Qualified audit reports

We are of the opinion that the negative perception attached to a qualified audit report is an aid to improving financial reporting. In many instances, it is this threat of a qualification in the audit report which gives added leverage to the auditor when debating with management valuation or disclosure issues. We also believe that the absence of qualifications in the audit reports of listed entities is rather an overall positive endorsement of the quality of financial reporting in the public arena.

We do believe there is scope, however, to revisit the structure of the audit report, in particular with reference to a 'justification of opinion' paragraph. In certain countries this already applies and gives the auditor the opportunity to draw attention to changes in accounting principles, to the impact of critical estimates and to material transactions which in its view is important to interpretation of the financial statements. Such disclosures are also made elsewhere in the financial statements and remain the responsibility of management, but this is the auditor's opportunity to reinforce their importance.

Better external communication

We believe that disclosure of issues including choices surrounding accounting policies and exposure to future risks or events and their potential impact should remain the responsibility of management. We believe it could prove confusing for there to be multiple disclosures in an audit report on these issues. However, we concur with the principle that timely reporting is important for stakeholders; the framework for public reporting, however, is not one which is set by the auditor but rather by prevailing law in the local jurisdiction.

Better internal communication

The Green Paper proposes regular dialogue between the auditor and the Audit Committee. We believe that the framework for such dialogue already exists in current ISA and it is for both the auditor and the Audit Committee to ensure that this framework is rigorously applied. We see no link, as is suggested, between enhanced dialogue and compromise of auditor independence.

Corporate Social and Environmental Responsibility (CSR)

We believe that the framework for financial reporting and the framework for CSR reporting should remain separate. Whilst there may be value to stakeholders in some degree of external scrutiny of CSR disclosures and whilst it may be that the auditor is well placed to fulfil that role, it is important that the roles are kept distinct and separate.

Extension of the auditor's mandate

The Green Paper considers whether the audit remit should be extended to cover forward looking information. The audit remit currently covers this to a certain degree in the context of going concern. We believe that to extend this further would add considerable cost to the audit process and in practice would be subject to such an array of caveats, that value to stakeholders would be minimal.

Q4	Do you believe that audits should provide comfort on the financial health of companies? Are audits fit for such a purpose?	The current audit framework is such that audits are not fit for such a purpose and we do not consider that the framework should be extended to enable audits to perform such a role. We are also concerned as to the concept and definition of 'financial health'.
Q5	To bridge the expectation gap and in order to clarify the role of audits, should the audit methodology employed be better explained to users?	Whilst there is scope to improve public understanding of audits and their remit, we do not believe that more public explanation of audit methodology is required or would be helpful. The audit methodology framework is set out in ISA's which is publicly available.
Q6	Should professional scepticism be reinforced? How could this be achieved?	We believe there is scope for such reinforcement through a combination of actions, including a further strengthening of the role and requirements of the Audit Committee. We also consider that dual signatures on the audit report may be one of the measures to support this.
Q7	Should the negative perception attached to qualifications in audit reports be reconsidered? If so, how?	No. The negative perception is fairly held given the current qualification framework and in some circumstances leads to an improvement in the quality of financial reporting. However, we

		believe there is merit in reviewing the structure of the audit report with the possible inclusion of a 'justification of opinion' paragraph.
Q8	What additional information should be provided to external stakeholders and how?	We consider there to be a case for enhanced regulatory, CSR or internal control reporting, but that this should be kept separate from the framework for annual financial reporting.
Q9	Is there adequate and regular dialogue between the external auditors, internal auditors and the Audit Committee?	The question would need to be addressed on a case by case basis; however, we consider the framework for such dialogue broadly to be in place and it is the responsibility of each of the parties to ensure the framework is rigorously applied. An extension of guidance in respect of reporting might be helpful as already applies in certain jurisdictions. There is also scope in some countries to extend the requirement for Audit Committees.
Q10	Do you think auditors should play a role in ensuring the reliability of the information companies are reporting in the field of CSR?	We believe that whilst auditors might be well placed to perform such a role, it is important to keep the CSR and the financial reporting frameworks distinct and separate.
Q11	Should there be more regular communication by the auditor to stakeholders? Also, should the time gap between the year end and the date of the audit opinion be reduced?	We do not see any mechanism for reporting to stakeholders in general outside of the annual financial reporting framework. The timeliness of reporting of the audit opinion is driven largely by local law as applies in the jurisdiction and there may be scope to attempt to harmonize these. Specific additional reporting, for example to Regulators, may be of benefit but it is important to distinguish between listed and private companies.
Q12	What other measures could be envisaged to enhance the value of audits?	None which is not already covered elsewhere in our response or in the Green Paper.

International Standards on Auditing

Q13	What are your views on the introduction of ISA's in the EU	We are supportive of achieving a common platform of Auditing Standards across Europe.
Q14	Should ISA's be made legally binding throughout the EU?	We believe that ISA's should be made legally binding across all member states, but not themselves enshrined in law. We believe that they should not be subject to endorsement by individual member states, as we consider this to be an administrative burden, which slows down the process and is counter to the principle of achieving a common framework.
Q15	Should ISA's be further adapted to meet the needs of SME's and SMP's?	No. We consider that ISA's as currently drafted are universally applicable and translate easily into the SME and SMP marketplace.

Governance and Independence of Audit Firms

General comments

Appointment and remuneration of auditors

Whilst it is difficult necessarily to conclude that a lack of independence has played a material role in some of the issues arising out of the financial crisis, it is nevertheless fundamental to establishing trust in the audit function that auditors are, and are seen to be, independent. Accordingly we believe there is merit in looking at an independent body whose remit would be to work with Audit Committees to ensure that regular and open tendering is applied to audit appointments, that consideration of audit remuneration remains robustly independent of management and that due consideration is being given to reducing the risk from market concentration.

The concept of independence is of course fundamental to the audit of all companies, whether large or not and so it could be argued therefore that a concept of 'scalable independence' has no validity. However, we consider that the balance of stakeholder needs changes for smaller companies, such that the current system of appointment and remuneration by the audited body can remain intact, subject of course to relevant safeguards.

Mandatory Rotation

We do not support mandatory rotation but we believe that mandatory tendering after a certain period is important. There could be any number of reasons why an incumbent audit firm is the right choice to undertake the audit appointment and in these circumstances a mandated rotation would seem to run counter to principle of audit quality.

Non audit services

We consider that the principles of explicit independence should be extended to the provision of non audit services to major listed and systemic risk companies. However, we would stop short of banning the provision of such services. Instead we would favour a 'comply or explain' environment where there is an expectation that auditors would not be providing non-audit services for such companies. Where the Audit Committee considered it appropriate for this not to be the case, they should explain the rationale for their decision.

We are unclear as to why the Green Paper suggests that restriction of provision of non audit services by auditors to their audit clients might lead to the creation of 'pure audit firms'. The major accountancy firms have developed a multi service line business model for all sorts of very good reasons, including the ability to attract the best resource. If audit quality is to improve further, we have to create a vibrant and diverse accountancy industry which is able to attract the highest caliber applicants. We consider that restriction on the provision of non audit services to certain categories of clients as proposed above remains consistent with an accountancy industry comprising multi disciplinary firms.

Fee Structure

We consider that the question of limiting reliance on key clients is adequately covered by the IFAC Code of Ethics. However, we believe there is scope to extend its application to cover the position of dependence of individual partners on key clients and the relevant safeguards expected to be put in place by firms.

Publication of Financial Statements

We support the principle of transparency with respect to systemic audit firms' own financial statements, which we believe should reflect their global operations, drawn up as combined financial statements where this is applicable. We consider the requirement for transparency for second tier networks to be less compelling due to their reduced importance to the issue of systemic risk. In these instances the publication of annual reviews with high level key performance indicators should be sufficient.

Organisational requirements

We believe there is merit in encouraging wider use of independent non-executives. However it is for the Regulator to ensure that audit firms have appropriate independence procedures in place. We are also not convinced that the principle of extending access from individual shareholders of an audited company to the auditor is either practical or desirable.

Revisiting ownership rules and the partnership model

We support the principle that the rules around the partnership model should be relaxed. Access to capital could be an ingredient in enabling second tier firm growth, although this should come with strong controls over maintenance of independence in a firm's governance structure.

Group audits

We consider that the revised ISA 600 clearly sets out the roles and responsibilities of the group auditor. The Commission should look further at ways of enforcing compliance between firms in different jurisdictions as in practice this is running counter to the objective of opening the market to further competition.

Q16	Is there conflict in the auditor being appointed and remunerated by the audited entity? What alternative arrangements would you recommend in this context?	We believe that the Commission should investigate the possibility of establishing an independent body to work with Audit Committees in reviewing their audit appointment procedures, with an explicit agenda of ensuring * regular and open tendering; * independence from management in setting audit remuneration; and * reduction in market concentration.
Q17	Would the appointment by a third party be justified in certain circumstances?	No – see our comments above.
Q18	Should the continuous engagement of audit firms be limited in time? If so, what should be the maximum length of an audit firm engagement?	We do not support the principle of mandated firm rotation, but we would support mandated tendering for listed companies. We believe a period of 5 to 7 years for such mandated tendering may be appropriate.
Q19	Should the provision of non audit services by audit firms be prohibited?	No, but there should be rebuttable presumption that audit firms supply only audit services to large listed and systemic

		risk companies. Where this is not the case, there should be a 'comply or explain' requirement on the Audit Committee to justify why they believe it is appropriate for the company's auditors to be providing other services.
Q20	Should the maximum level of fees an audit firm can receive from a single client be regulated?	We consider this issue is adequately covered in the existing IFAC Ethics guidance in respect of firms. However, we believe this should be extended to cover the reliance of individual partners on major clients.
Q21	Should new rules be introduced regarding the transparency of the financial statements of audit firms?	We believe that greater transparency of the Big 4 audit firms would be helpful, including a requirement to publish combined accounts. The argument for this to apply to 'second tier' networks is less compelling.
Q22	What further measures could be envisaged in the governance of audit firms to enhance the independence of auditors?	We believe that wider use of independent non executives may have merit.
Q23	Should alternative structures be explored to allow audit firms to raise capital from external sources?	Whilst lack of access to capital is not a major factor in restricting growth, we believe a relaxation of the rules regarding structures would nevertheless be helpful.
Q24	Do you support the suggestions regarding Group Auditors? Do you have any further ideas on the matter?	Yes. We support the rigorous implementation of ISA 600 across jurisdictions and across firms. There is a behavioral issue in some firms which is proving anti-competitive.

Supervision

We agree with the proposals set out in the Green Paper and have no further comments to make in this area.

Concentration and Market Structure

General comments

Subject to the areas of independence and governance as discussed in the Green Paper, we are generally supportive of the role of market forces in developing a global audit profession. The Big 4 have developed a scale and a capacity to deliver the largest global audits which is out of reach for any other firm in the medium term and many second tier firms would question the attractiveness of pursuing a global strategy along these lines. This clearly creates a position of market dominance.

It is, however, right to try and address the question of 'Big 4 is best' as applies across a whole range of financial services, including assurance related activities, where there is capacity and expertise outside the Big 4.

Joint audits / audit consortia

We support the idea of audit consortia, operating either as joint auditor or through a principal and secondary auditor relationship. However, we believe further thinking needs to be applied as to their introduction. An immediate mandating of their introduction to the largest listed companies and other financial institutions would introduce significant stress into the audit market in the short term and, rather than leading to an opening of the market, may merely give rise to a realignment of the existing providers.

Accordingly we favour a 'best practice' approach with the involvement of both institutional investors and an independent body working with Audit Committees, with the clear aim of introducing the principles of audit consortia in a determined and clear time frame, supported by a phased roadmap for mandating their introduction. Current second tier firms need the certainty of the creation of such a market together with the risk and reward profile of that market if they are to make investment and resourcing decisions.

Mandatory rotation of auditors and re-tendering

Our views on this area have been expressed earlier.

Addressing the 'Big 4 is Best' bias

This is a complex area where we believe there is limited amount which can be achieved by legislation. The Big 4 currently train the vast majority of auditors and thus there is behavioral bias when people leave the profession and become involved in appointing auditors, as Big 4 'is all they know'.

However, we do believe there is scope to introduce greater competition in public sector assurance services through mandating the inclusion of non Big 4 firms in tendering opportunities.

Reassessment of the drivers of previous consolidation

The principal drivers behind the consolidation of audit firms into the Big 4 have been the requirement by increasingly globalised companies to have increasingly globalised audit firms and for those firms to be of a size to undertake significant investment in their own products to meet an increasingly sophisticated financial market.

The sheer size and dominance of the Big 4 has also enabled them to defend that position very effectively against potential new market entrants. We cannot see that these previous drivers of consolidation are likely to reverse.

We see the role of the Commission in addressing this issue as being one of intervention to help create market opportunities rather than seeking to intervene directly in the disaggregation of a global industry.

Q27	Could the current configuration of the audit market present a systemic risk?	Yes
Q28	Do you believe that the mandatory formation of an audit firm consortium with the inclusion of at least one smaller, non systemic audit firm could act as a catalyst for dynamising the audit market.....?	We are supportive of the principles of audit consortia, whether that is joint responsibility for the opinion, or a 'sub contractor' relationship. We believe further thinking needs to be applied as to their introduction, but favour a 'best practice' approach in the short term with a phased roadmap for mandating their introduction.
Q29	From the viewpoint of enhancing the structure of audit markets, do you agree to mandatory rotation and tendering after a fixed period? What should be the length of such a period?	We support mandatory tendering for listed companies every 5 to 7 years, but do not support mandatory rotation.
Q30	How should the Big 4 bias be addressed?	We believe there is limited scope for the Commission in respect of the private sector, but we would support the principle of creating wider access to second tier firms in public sector assurance assignments.
Q31	Do you agree that contingency plans, including living wills, could be key in	We support this proposal and would extend the principle to the major

	addressing systemic risks and risk of firm failure?	audited companies. We believe that Audit Committees should always have regard to alternative audit providers in the event of failure of their current provider.
Q32	Is the broader rationale for consolidation of large audit firms over the past two decades still valid? In which circumstances could a reversal be envisaged?	We believe the drivers of consolidation remain relevant and it is difficult to see a legitimate role for the Commission to seek to 'undo' the current structure of the major firms.

Creation of a European Market

General comments

In our view, any actions which remove barriers to international mobility, both within the European Union and outside, are to be encouraged. The mutual professional recognition issues between countries around the world are confusing, opaque and in our experience inconsistently applied.

However, it is worth noting that the major accounting networks outside the Big 4 play an important role in addressing this issue.

Q33	What in your view is the best manner to enhance cross border mobility of audit professionals?	Clear and enforced mutual recognition of professional qualifications.
Q34	Do you agree with 'maximum harmonisation' combined with a single European passport for auditors and audit firms? Do you believe this should also apply for smaller firms?	We are in agreement with the principles of 'maximum harmonisation'. The qualification for such a passport should be based purely on quality criteria and should not be dependent on size.

Simplification: Small and Medium Sized Enterprises and Practitioners

General comments

Small and medium sized enterprises

Much of the thrust of the Green Paper is focused on improving quality and improving understanding and transparency of audit. In our view, the creation of a principle of ‘audit lite’ either through limited audits or statutory reviews runs counter to these principles. Whilst such limited reviews may be operational in some countries, it is our experience in others that stakeholders are confused about their remit and the extent to which reliance could be placed on the opinion given. Accordingly they soon fall into disrepute.

Small and medium sized practitioners

As noted above, we are not in favour of the concepts of limited audit or statutory review as we believe it would introduce confusion into the market on behalf of stakeholders. Compilation reports, however, should continue to have a place in financial reporting.

Q35	Would you favour a lower level of service than an audit, a so called ‘limited audit’ or ‘statutory review’ for the financial statements of SME’s instead of a statutory audit?	No
Q36	Should there be a safe harbour regarding any potential future prohibition of non-audit services when servicing SME clients?	Yes. As indicated earlier, we favour a ‘comply or explain’ regime in respect of the provision of non audit services to audit clients. However, in the event that prohibition was introduced, this should be applied only to large listed and systemic risk companies.
Q37	Should a ‘limited audit’ or ‘statutory review’ be accompanied by less burdensome internal quality control rules....?	Please refer to our response to question 35.

International Cooperation

General comments

Mutual reliance on inspection regimes is a key component of enhancing the overall quality of the oversight of auditors operating on a global basis. One of the apparent barriers to

such reliance lies in the fact that the detail and scope of inspection programmes vary widely. Some countries may be willing to accept inspection programmes that operate to the same principles but differ in the detail of their application. Others however may well require that they must be equivalent at a more detailed level. To enhance international co-operation a framework of principles for inspection programmes should be established which will be adequate as a basis of mutual recognition for all countries.

Regulators should also be encouraged to share information between them when they identify matters affecting the global procedures of accountancy firms, rather than working in isolation. Quality could also be enhanced through reviews of firms who act for the major global companies being carried out on a coordinated basis by a number of regulators acting together to a common review programme.

Q38	What measures could in your view enhance the quality of the oversight of global audit players through international cooperation?	Establishment of a framework of principles for inspection programmes and coordination of reviews by individual regulators.
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